Quarterly Assessment of Financial System, No. 35, Q II/2021

Summary

As a result of the ease of containment measures for protecting the public health, economic activity has marked an increase in the first half of 2021. Based on KAS estimates, real GDP marked an accelerated increase of 5.6%, during Q1 2021. Accelerated growth of the economic activity is estimated to have continued also in Q2 2021, estimates which are based on increased exports of goods and services, consumption and public investments, as well as increased industrial production and retail trade.

Assets of the financial system, at the end of June 2021, reached a value of EUR 8.31 billion, representing an annual increase of 12.2%. Also on quarterly basis, financial system expanded, mainly being supported by the banking sector (deposits) and pension sector (collected contributions and return on investments). Also other sectors had positive contribution to the growth, however at low level due to the low weight they have in the financial system.

On quarterly basis, the banking sector activity within assets was supported by the increase in lending, whereas other balance sheet items declined (balance sheets with commercial banks, investments in securities, and money held at commercial banks). Whereas, within liabilities, deposits marked the most significant increase in this quarter (mainly from deposits collected from households) and equity (realized profit).

In terms of indicators that measure the health of the banking sector, at the end of Q2 2021, the sector turns out to have increased stability through improving the liquidity level, capitalization, profitability and higher quality of the loan portfolio.

Pension sector was characterized with positive dynamics in overall assets and investments performance as well, in Q2 2021. The increase in contributions collected during this period as well as the positive return on investments, contributed to the increase in the sector's assets, despite the impact of the withdrawal of 10% of funds from contributors, an opportunity which terminated at the beginning of this quarter.

With an increase were characterized also assets of insurance sector during the second quarter of 2021. Also, accelerated growth was marked by gross written premiums against claims incurred, which resulted in positive performance of the sector in this quarter.

Compared to last year, the microfinance sector marked an acceleration of lending activity, translated into an acceleration of assets growth on a quarterly basis. The sector also closed the second quarter with a positive financial result and a satisfactory level of credit portfolio quality based on the low level of nonperforming loans.

During the second quarter of 2021, the Government of Kosovo issued debt in the amount of EUR 100.0 million, through treasury bonds with a maturity of 3 to 10 years. Also, in auctions during this quarter, the submitted bidding amount to invest in government bonds exceeded the offer by 1.46 times.

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This publication includes the data available until 30 June 2021.

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Macroeconomic Developments[1]

As a result of the ease of containment measures for protecting the public health, economic activity has marked an increase in the first half of 2021. Based on KAS estimates, real GDP marked an accelerated increase of 5.6%, during Q1 2021. Accelerated growth of the economic activity is estimated to have continued also in Q2 2021, estimates which are based mainly on increased exports of goods and services, consumption and public investments, as well as increased industrial production and retail trade.

Consumer prices increased by 2.1%, in Q2 2021, mainly due to the increase in prices of communication means, transport, alcoholic beverages and tobacco, health services, education, hotels, recreation and culture.

Improving economic activity as a result of mitigating the negative effects of the Covid-19 pandemic has been translated into improving the performance of budget revenues. Budget revenues, in Q2 2021, marked an increase of 45.3%, while budget expenditures marked a decline of 4.6%, making the Kosovo budget record a primary surplus of EUR 46.9 million. Public debt reached EUR 1.6 billion, which is for 24.3% higher compared to Q2 2020. As a percentage to GDP, public debt reached 23.2%, from 18.2%.

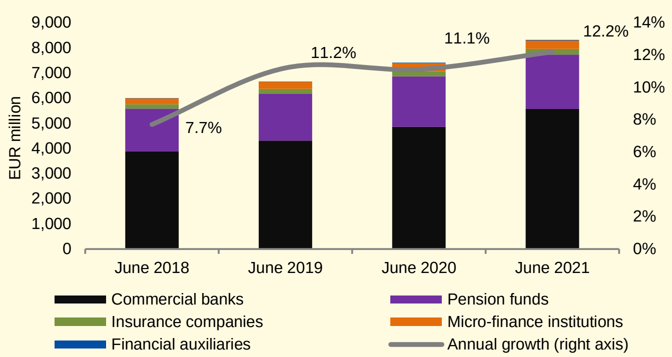
The current account deficit has doubled in Q2 2021, mainly due to the increase in the goods deficit and the decline in the positive balance of primary income, while the balance of services and secondary income has improved. The trade deficit of goods was EUR 952.0 million or 56.6% higher compared to Q2 2020, a dynamic that was mainly attributed to the significant increase of import, despite the considerable increase of export. Within the balance of payments, a considerable increase was marked also by remittances in Q2 2021 (24.8%), and FDI (78.8%).

[1] For more information on macroeconomic developments, please refer to: Quarterly Assessment of Macroeconomic Developments (Q2 2021) published at the CBK website.

Financial System

Assets of the financial system, at the end of June 2021, reached a value of EUR 8.31 billion, representing the highest annual increase in the last ten previous years. Moreover, for the third year in a row, assets of the financial system marked a double-digit growth (chart 1), which is mainly supported by the expansion of the banking and pension sector. Other sectors had positive impact on the increase of system's assets, albeit their contribution was of a low level.

Chart 1. Assets valueof Kosovo's financial system

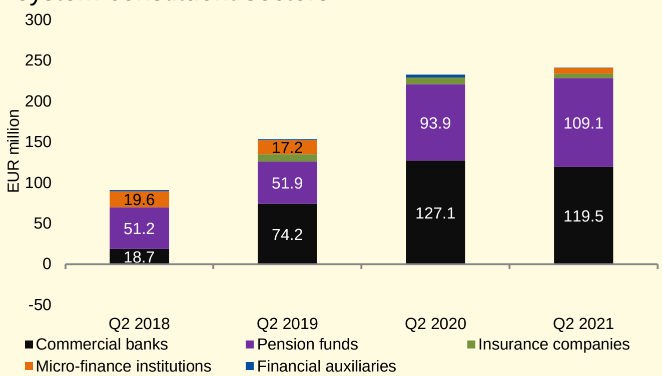


Note: The data are as at end of the noted quarter
Source: CBK.

Banking sector had the main contribution to assets growth of the financial system in the reporting period, marking an annual increase of 14.8% in June 2021 (12.7% in the same period of the previous year). The second largest sector within the financial system, the pension sector, continued the growth trend of last year with 7.5% in June 2021 (7.6% annual growth in June 2020). Also other sectors had positive contribution to the growth of assets of the system, albeit at lower level due to their low weight they have in the financial system. Insurance sector marked an accelerated increase of its activity, while the microfinance sector was characterized with a slowdown increase compared to the same period of the previous year.

On quarterly basis, financial system assets increased by EUR 241.3 million, primarily being affected by the banking sector activity (EUR +119.5 million) and the pension sector (EUR +109.1 million). Insurance sector increased by EUR 5.5 million, while microfinance sector marked an increase of EUR 7.0 million.

Chart 2. Quarterly change of assets of financial system constituent sectors



Source: CBK.

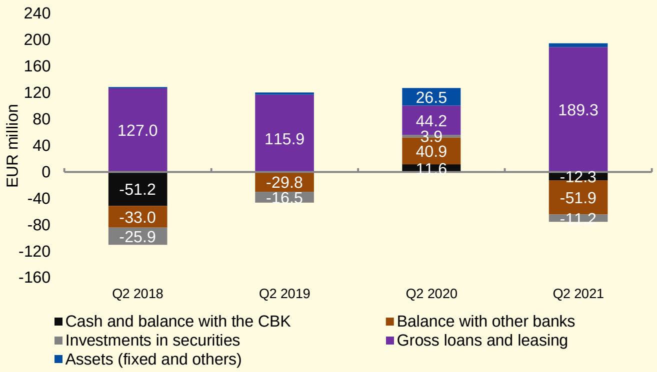
The increase in assets of the banking sector in this quarter reflects mainly the increase of deposits level and the increase of capital (mainly the profit realized in this period), while the increase of the activity of the pension sector was attributed to the increase in contributions received and return on investments.

Banking Sector

Within the assets of the banking sector, lending activity was the only item that was characterized by growth, while other items in this quarter decreased, which was more pronounced in the activity with commercial banks. Whereas, within liabilities, deposits and own resources (from the profit realized during Q2 2021) were the categories that marked the highest growth.

Soundness indicators of the banking sector at the end of this quarter were at higher levels compared to the same period of the previous year. Consequently, the sector increased the level of capitalization, liquidity and marked an improvement of credit portfolio quality.

Chart 3. Banking sector assets structure in the respective quarters



Source: CBK.

Assets

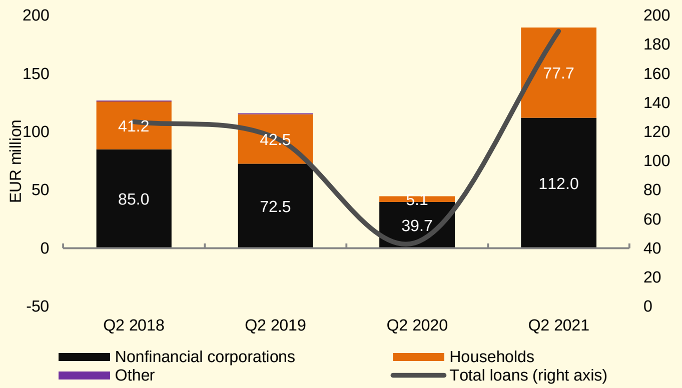
The value of total assets of the banking sector at the end of Q2 2021, reached EUR 5.57 billion, representing the highest annual growth since the same period of 2011, reaching 14.8%. This sharp increase in the activity of the sector mainly reflects the increase in the level of deposits, which were used primarily to finance lending.On a quarterly basis, assets of the banking sector increased by EUR 119.5 million during Q2 2021. Lending activity of the banking sector (which has the largest weight within the assets of the sector, with a share of 63.0%) marked an increase of EUR 189.3 million in this quarter (chart 3). Other categories within assets marked a decline compared to Q2 2020. The category of balance sheet with commercial banks, which is mainly comprised by deposits and the like, invested in banks abroad, marked a sharper decline in Q2 2021 with EUR -51.9 million. The category of investments in securities marked a decline of EUR -11.2 million in this quarter. Also, the category of cash held at the treasury of the CBK declined for EUR -12.3 million in Q2 2021.

Loans

The value of total loans at the end of June 2021, reached EUR 3.51 billion, representing an annual increase of 12.2% (an increase of 6.4% marked at the end of June 2020). Lending activity accelerated its growth pace compared to June 2020, and also exceeded the growth trend marked during 2017-2019. Loans to nonfinancial corporations, with a share of 62.8% of total loans, marked an annual increase of 10.8% (6.3% at the end of June 2020).

Similarly, also loans to households marked an accelerated increase, reaching 14.8% from 6.8%, as it was in June 2020.

Chart 4. Quarterly change of loans stock



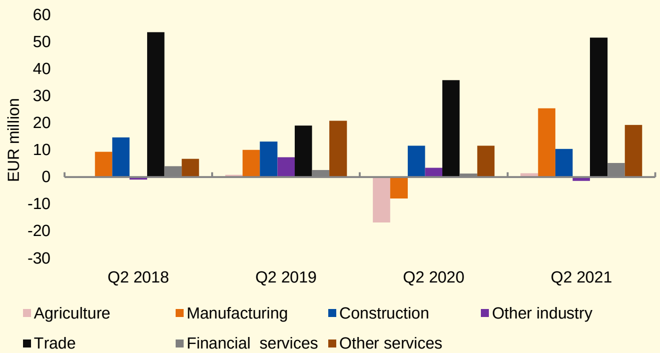
Source: CBK.

Also, on quarterly basis, lending activity marked an accelerated increase, thus compensating the slowdown increase marked in the same period of the previous year. Total loans, on quarterly basis, increased for

EUR 189.3 million in Q2 2021 (EUR +44.2 million marked in Q2 2020). Loans to households increased by EUR 77.7 million during Q2 2021 (EUR +5.1 million during Q2 2020), while loans to nonfinancial corporations increased by EUR 112.0 million (EUR +39.7 million during Q2 2020) (chart 4).

In terms of economic activities, on quarterly basis, the sectors with the largest share of active loans stock were characterized by growth.

Chart 5. Quarterly change on loans to nonfinancial corporations, by economic activity

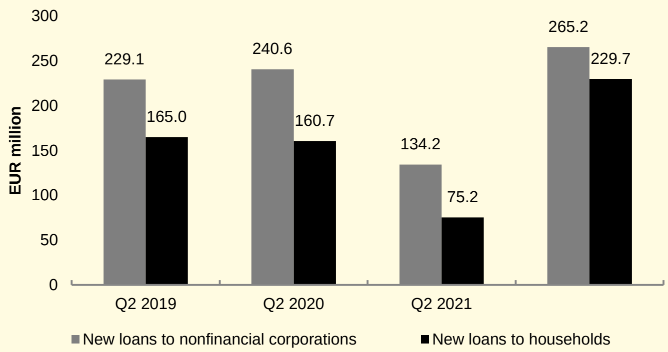


Source: CBK.

Lending to the main sectors of the economy, such as trade, manufacturing, construction and agriculture, were characterized by a growth in this quarter. With a decline of lending in this quarter was characterized only the sector of energy.

In Q2 2021, new loans reached the value of EUR 494.9 million (EUR +209.4 million in Q2 2020). New loans to nonfinancial corporations amounted to EUR 265.2 million in Q2 2021 (EUR +134.2 million, in Q2 2020)(chart 6). A significant increase was marked by loans with non-investment purposes, which in Q2 2021 reached an amount of EUR 114.8 million (EUR +36.1 million in Q2 2020). Loans with investment purpose in this period reached the value of EUR 145.4 million (EUR +95.3 million in Q2 2020). In sectoral terms, new loans to all sectors increased, with special emphasis on new loans to industry and services.

Chart 6. New loans to nonfinancial corporations and households, in Q2



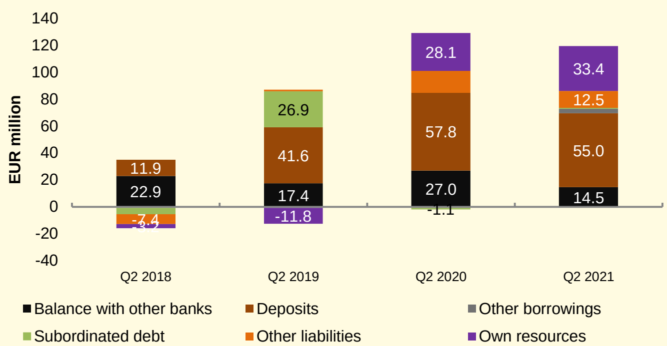
Source: CBK.

Similarly, also new loans to households marked a significant increase during this period compared to previous year. The value of total new loans, in Q2 2021, was for EUR 154.5 million higher against Q2 2020, amounting to EUR 229.7 million. Of which, new consumer credit marked a sharper increase at EUR 165.4 million in Q2 2021 (EUR +49.2 EUR during Q2 2020). Similarly, also new mortgage loans were characterized with an increase of EUR 53.3 million in Q2 2021 (EUR +21.3 million marked in Q2 2020).

Liabilities and Own Resources

The structure of liabilities and own resources are mainly comprised by deposits (80.4%), whose stock, at the end of June 2021 reached EUR 4.48 billion marking an annual growth of 14.7% (14.0% in June 2020). Also, on quarterly basis, deposits marked a significant increase compared to Q2 2020 (chart 7). The category of own resources of the sector increased by EUR 33.4 million in Q2 2021 (EUR + 28.1 million in Q2 2020), as a consequence of the profit realized in this period. At the end of June 2021, the stock of total equity reached the value of EUR 675.3 million, marking an annual increase of 18.5%.

Chart 7. Structure of liabilities and own resources, quarterly change



Source: CBK.

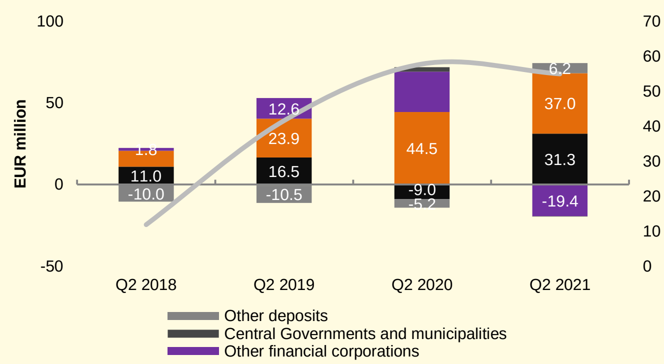
Deposits

For the third consecutive year, in the reporting period, deposits marked a double digit increase. Households continue to have the main contribution to the growth of total deposits, followed by deposits collected from non-financial corporations (businesses) and other public corporations (public enterprises).

On quarterly basis, only in Q2 2021, deposits increased by EUR 55.0 million (an increase of EUR 57.8 million, in Q2 2020). Deposits collected from households, during Q2 2021, increased by EUR 37.0 million (EUR +44.5 million in Q2 2020), while the stock value at the end of the period reached EUR 3.07 billion. On the other side, deposits collected from nonfinancial corporations during this period increased by EUR 31.3 million (EUR -9.0 million in Q2 2020), while the stock value at the end of the period reached EUR 823.3 million.

Deposits from other financial corporations, in this quarter, declined by EUR 19.4 million (EUR +24.6 million in Q2 2020), which mainly reflects the developments in the pension sector and their investment strategy (domestically and abroad). At the end of the period, the stock of this category amounted to EUR 250.5 million.

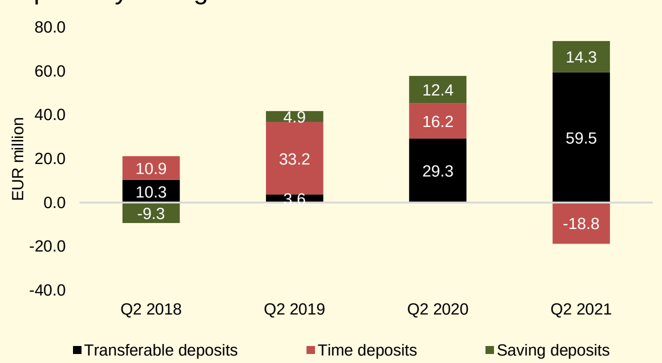
Chart 8. Deposits by sources, quarterly change



Source: CBK.

According to the categories of deposits, transferable deposits expanded by a value of EUR 59.5 million (EUR +29.3 million in Q2 2020) on quarterly basis, while their stock reached the value of EUR 2.87 billion at the end of the period (June 2021) (chart 9).

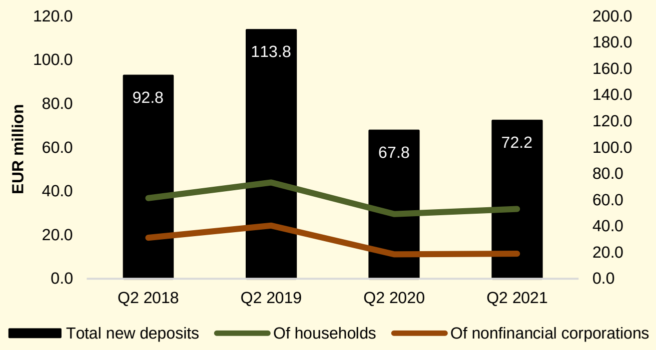
Chart 9. Deposits structure by main categories, quarterly change



Source: CBK.

At the same period, time deposits marked a decline of EUR 18.8 million (+16.2 million in Q2 2020), reaching the value EUR 1.01 billion at the end of the period (June 2021). Whereas, saving deposits marked an increase of EUR 14.3 EUR million (+12.4 million in Q2 2020), reaching the value EUR 595.0 million, at the end of the period (June 2021).

Chart 9-A. New collected deposits, quarterly change



Source: CBK.

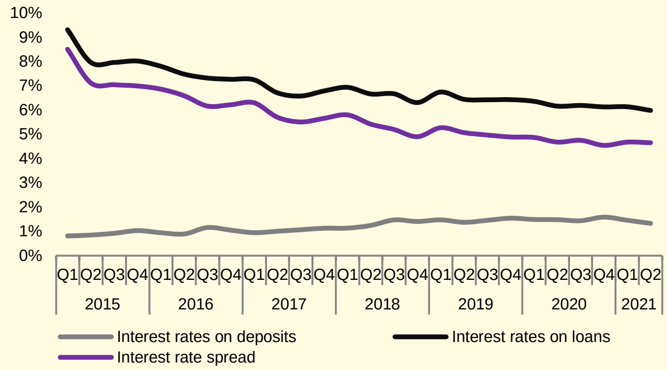
Transferable deposits continued to have the highest share to total deposits of the sector (64.2%), followed by time deposits (22.6%) and saving deposits (13.3%).

The value of new collected deposits[2], in Q2 2021, was EUR 72.2 million, of which EUR 53.1 million were deposits collected from households, whereas the remainder from nonfinancial corporations (chart 9A).

Interest Rates[3]

The average interest rate on loans, in Q2 2021, was 6.0%, or 0.2 percentage points lower against the same period of the previous year. Whereas, also interest rates on deposits marked a decline for 0.2 percentage points compared to the previous periods, standing at 1.3%, in Q2 2021. Consequently, the interest rate spread of loans and deposits stood at 4.7 percentage points, the same as in the previous period (chart 10).

Chart 10. Interest rate on loans and deposits



Source: CBK.

Interest rates on loans

Average interest rate on loans to nonfinancial corporations stood at 6.0% during Q2 2021, marking the similar rate as in the previous period (chart 11).

As regards to categories of loans, interest rate on investment loans was lower (5.9%) compared to interest rate on non-investment loans (6.1%). Compared to the same period of the previous year, there was a slight increase in the interest rate on investment loans (by 0.2 percentage points), while the interest rate on non-investment loans remained unchanged from the previous period. In sectoral term, the interest rate on agricultural loans marked an increase of 0.7 percentage points, reaching an average of 8.4% in Q2 2021%.

Similarly, also interest rates on loans to industry marked a growth of 0.2 percentage points, reaching 6.0%.

The interest rate on loans to the services sector remained unchanged at 5.9%. While, the interest rate

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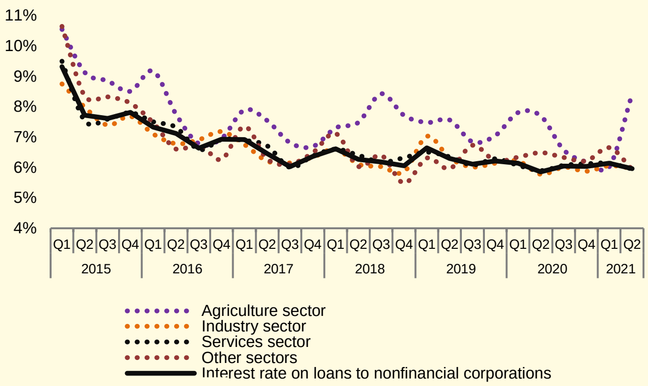
[2] New deposits include time deposits.

[3] The calculation of interest rates: quarterly average of interest rates on loans and deposits. In the text it is referred as "the interest rates".

on loans to other sectors loans marked a decline of 0.5 percentage points, falling at 5.9%.

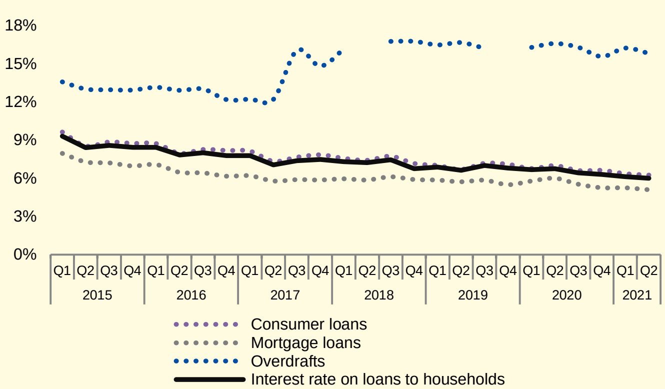
Chart 11. Interest rates on loans to nonfinancial corporations



Source: CBK.

Within loans to households, average interest rate on loans marked a more notable decline of 0.7 percentage points, dropping at 6.0%, in Q2 2021. A higher interest rate was marked by consumer credit (6.2%), which recorded a decline of 0.7 percentage points compared to Q2 2020. While, interest rate applied to mortgage loans stood at 5.1% in Q2 2021, representing a decline of 0.9 percentage points compared to Q2 2020 (chart 12).

Chart 12. Interest rates on loans to households

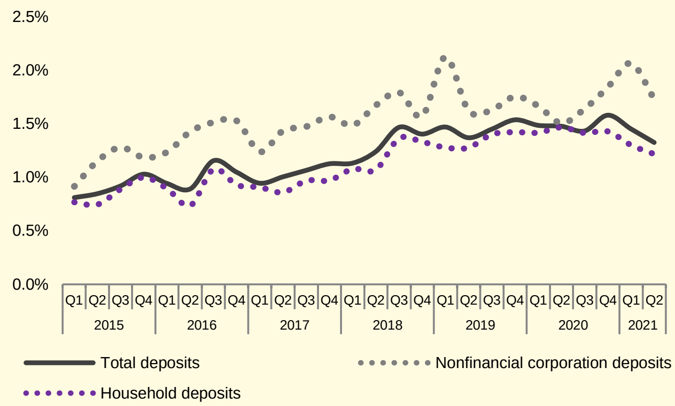


Source: CBK.

Interest rates on deposits

The average interest rate on deposits marked a marginal decline compared to the previous period (for 0.2 percentage points), standing at 1.3% (chart 13).

Chart 13. Interest rates on deposits

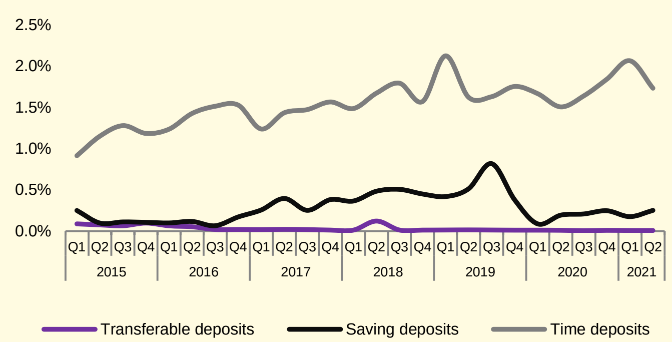


Source: CBK.

Interest rates on nonfinancial corporation deposits, continued to be more favorable compared to those of households, although the difference between them is not high.

Interest rates on nonfinancial corporation deposits stood at 1.7% (1.5% in Q2 2020) (chart 14).

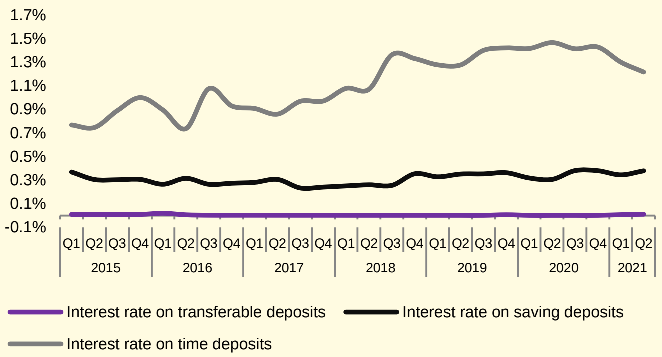
Chart 14. Interest rate on nonfinancial corporation deposits, by categories



Source: CBK.

While, interest rate on household deposits marked a marginal decline compared to the same period of the previous year. Average interest rate on household deposits stood at 1.3% (1.5% in Q2 2020) (chart 15).

Chart 15. Interest rates on household deposits, by categories



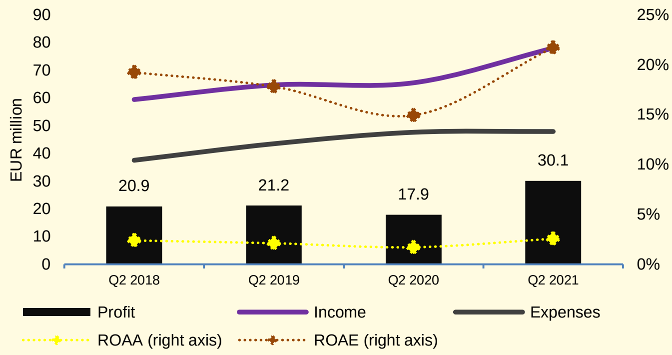
Source: CBK.

Performance of the Banking Sector

The banking sector realized a profit with a value of EUR 30.1 million, in Q2 2021, which is for EUR 12.3 million higher compared to Q2 2020 (chart 16). The high profit realized in Q2 2021 was mainly a result of the higher increase of income (for EUR 12.5 million) compared to the slower increase of expenditures (for EUR 0.3 million). During this quarter income amounted to EUR 78.0 million, where interest income (mainly interest income on loans) amounted to EUR 56.8 million (annual increase of EUR 7.1 million). Conversely, also non-interest income (primarily income from fees and commissions), marked an annual increase of EUR 5.2 million compared to Q2 2020 amounting to EUR 19.0 million at the end of the second quarter of 2021.

Expenditures of the banking sector marked a value of EUR 47.9 million in Q2 2021. The largest category, the one of general and administrative expenses reached the value of EUR 29.2 million, representing an increase of EUR 2.8 million compared to Q2 2020. The category of non-interest expenses, marked the value of EUR 9.4 million in Q2 2021 (for EUR 3.8 million lower compared to the previous period), mainly as a consequence of the lower share for expenses on possible loan loss provisions. Whereas, the category of interest expenses during this period decreased for EUR 0.2 million, thus falling at the value of EUR 5.8 million, in Q2 2021.

Chart 16. Profit and profitability indicators of the banking sector



Source: CBK.

The notable increase of income in this quarter (19.1%) against the slower increase in expenditures (0.6%), had an impact on expenditures to income ratio to improve, dropping to 61.4%, in Q2 2021. This ratio indicates that the banking sector spends EUR 0.614 for every EUR 1 earned (chart 16).

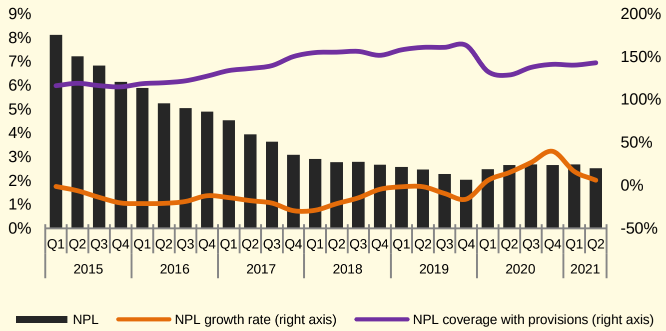
Financial Soundness Indicators

Financial soundness indicators of the banking sector continued to be at satisfactory level in Q2 2021, exceeding the minimum level as required by the regulation and marking a further improvement in Q2 2020.

Non-performing loans disrupted the increasing trend that had characterized the banking sector since Q1

2020 (with the emergence of the Covid-19 pandemic), for the first time, in Q2 2020. The NPL rate to total loans ratio stood at the level of 2.5%, in June 2021 (2.7% at the end of June 2020) (chart 17).

Chart 17. Nonperforming loans and provisions

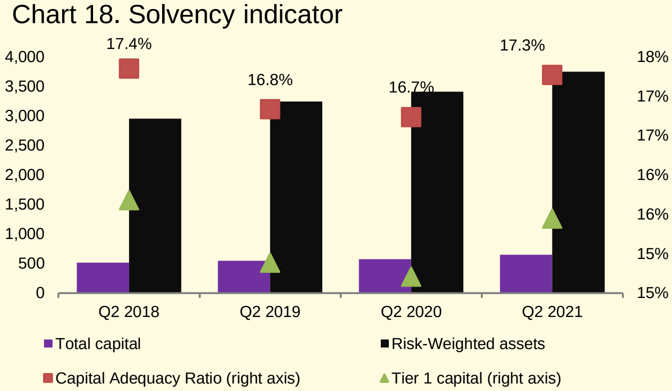


Note: The data are as at end of the noted quarter
Source: CBK.

Nonperforming loans continued to be well provisioned, at a level of 143.2% (129.0% at the end of June 2020).

As a result of the capital level inherited from the previous years and the profit realized in the second quarter of 2021, the level of capitalization of the banking sector stood at a satisfactory level.

Chart 18. Solvency indicator



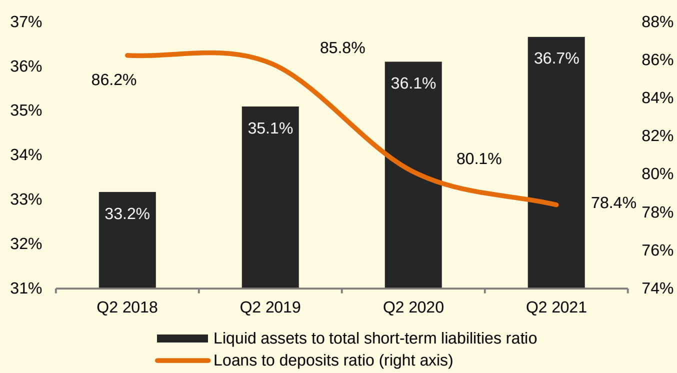
Note: The data are as at end of the noted quarter
Source: CBK.

During the reporting period, the Capital Adequacy Ratio stood at the level of 17.3%, representing a higher level for 0.5 percentage points than in the same period of the previous year (chart 18).

The increase of this indicator is attributable to the higher increase of the capital compared to the slower increase of risk weighted assets.

As regards to the liquidity of the banking sector, the liquid assets to short-term liabilities ratio marked a slight improvement of 0.6 percentage points compared to Q2 2020, standing at the level of 36.7%. The increase of this indicator, came as a result of the more accelerated increase of liquid assets (cash and its equivalents, the balance with other banks, investments in securities), compared to the slower increase of short-term liabilities (mainly transferable deposits).

Chart 19. Liquidity indicators

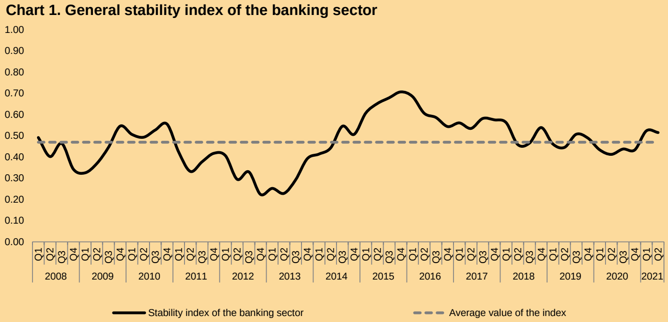


Note: The data are as at end of the noted quarter
Source: CBK.

Box 1. Stability index of the banking sector

Banking sector, before the outbreak of Covid-19 pandemic, operated in an environment with low risks level. However, since the second half of March 2020, when measures were taken to mitigate the health consequences of the new pandemic crisis, the potential risks to financial stability have increased. Although during 2020, the banking sector continued to maintain the level of liquidity, solvency, profitability and quality of the loan portfolio, the first half of 2021 was characterized by improvement in key indicators that measure the soundness of the banking sector. Being relied on the more frequent indicators of the banking sector, the stability index of the banking sector is constructed to measure and assess the internal soundness of the banking sector which reflect the stability of the banking sector. The index has been constructed on the basic financial indicators of the banking sector, taking the values ranging from 0 to 1, where the higher values represent a risk in decline and vice versa.[4] The index has been calculated on quarterly basis in order to assess the increase or the decline of the risk sensitivity through this index.

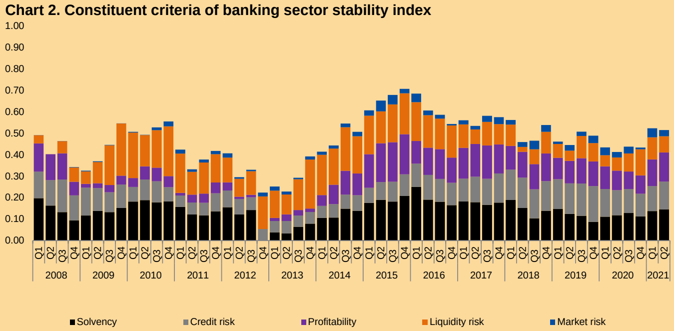
Chart 1. General stability index of the banking sector



Source: CBK.

Based on the general aggregated index of the sector's stability, at an average, it was marked a decline of the risk sensitivity (read: a growth of the index) in Q2 2021 compared to Q2 2020. The total value of the index, in Q2 2021, is above the average value of the index (chart 1), in contrast to the previous year where as a result of the pandemic crisis, the overall index turned out to stand below the historical average values in each quarter.

Chart 2. Constituent criteria of banking sector stability index



Source: CBK.

Compared to the same quarter of the previous year, all constituent indicators of the overall stability index of the banking sector were characterized by a decrease in risk sensitivity (read: increase in the index). The highest sensitivity decline was marked by profitability indicator, followed by credit risk indicator, solvency and liquidity indicators. It is worth mentioning that the indicator that measures the market risk has relatively low weight to the overall index and the fluctuations of this indicator do not pose risk for the banking sector as a result of the low level of assets held in foreign currency (chart 2).

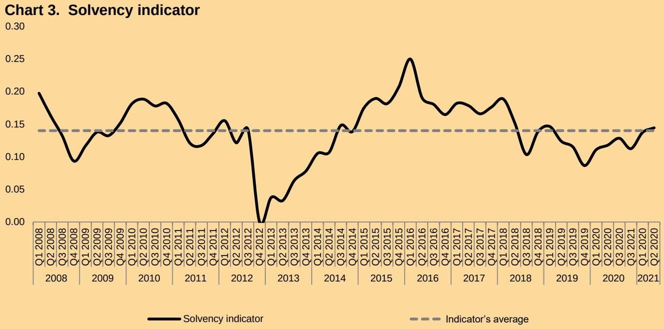
The decline of sensitivity to solvency risk, at the end of Q2 2021, compared to the statement marked in Q2 2020 is attributable to the increase of capitalization level of the banking sector. The increase of the capital has influenced the faster growth of regulatory capital against the slower growth of risk-bearing assets.

The increase of sensitivity to liquidity risk, in Q2 2021, compared to the level marked in the same period of the previous year, mainly is attributable to the higher increase of liquid assets compared to the slower

[4] For further details on the methodology of construction of the stability index of the banking sector, please refer to the Financial Stability Report no. 9.

growth of the short-term liabilities. Within the liquid assets, there was observed a significant increase of cash held at the CBK, at commercial banks and other financial institutions, and an increase in securities investments. Conversely, short-term liabilities marked a slower increase against the liquid assets, which mainly consist of deposits within a one year of maturity.

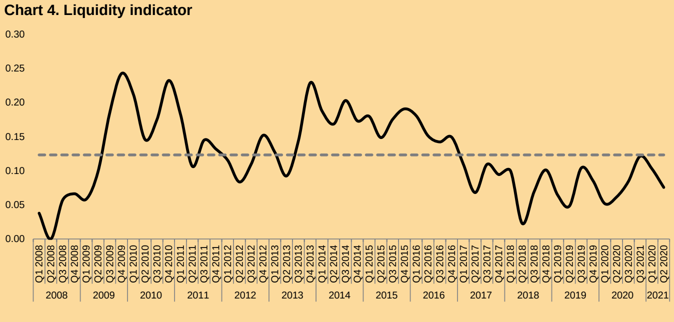
Chart 3. Solvency indicator



Source: CBK.

The decrease in credit risk sensitivity was mainly attributed to the slowdown in the growth value of nonperforming loans, while as a level they decreased compared to the same period of the previous year. This decline came as a result of the accelerated growth of lending activity until June 2021 compared to the same period of the previous year.

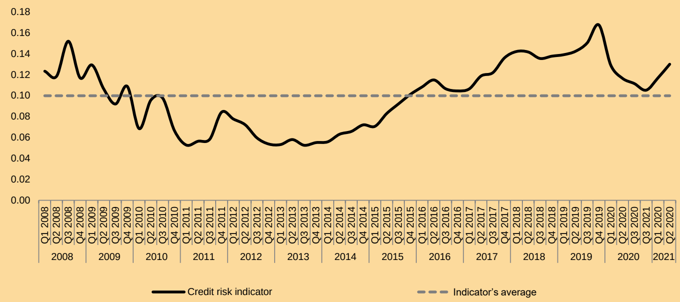
Chart 4. Liquidity indicator



Source: CBK.

The easing of anti-Covid 19 measures and the economic recovery marked in Q2 2021 turn out to be reflected positively in both credit demand and credit supply.

Chart 5. Credit risk indicator

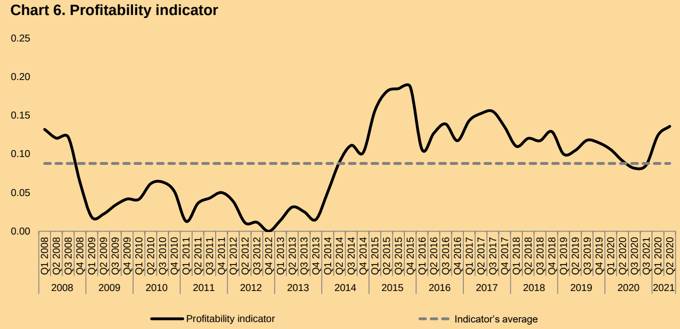


Source: CBK.

The decline of sensitivity to profitability risk is attributable to the developments in income and expenses of the banking sector during this period. The increase in the sector's income by 19.1% compared to the same period of the previous year was a result of interest income (mainly from loans) and non-interest income (mainly fees and commissions).

Whereas, expenditures increased by only 0.6%, which reflects the performance of general and administrative expenditures, while with a decline were characterized non-interest and interest expenses. The main contribution to the decrease in non-interest expenses was given by the reduction of loan loss provisions. Operating in a more profitable environment compared to the previous year, has also affected the improvement of the profitability indicator, such as the return on average equity (ROAE).

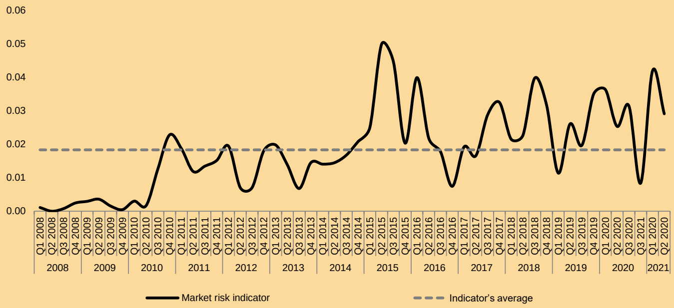
Chart 6. Profitability indicator



Source: CBK.

The decline of the market risk sensitivity was mainly attributable to the decrease of net position in foreign currency of the banking sector. This indicator has lower weight in the overall financial stability index due to the low level of exposure to both assets and liabilities. Moreover, also the level of loans and deposits in foreign currency is at a quite low level. As a consequence, movements of this indicator have quite low impact in the aggregated index of the financial stability.

Chart 7. Market risk indicator



Source: CBK.

Box 2. Countercyclical capital buffer[5]

Countercyclical Capital Buffer aims to strengthen financial stability by protecting the banking sector against losses that may be caused by the accumulation of cyclical systemic risk in an economy, as well as by influencing the provision of credit supply sustainability throughout the financial cycle. Countercyclical capital buffer is part of the Basel III regulatory framework and at the same time one of the main instruments of macroprudential policy to address the cyclical dimension of systemic risk.

For the calculation of countercyclical capital buffer, the guidelines of the Basel Banking Supervision Committee suggest monitoring some parameters for assessing whether lending is growing beyond sustainable fundamentals and is consequently affecting the accumulation of systemic risk. In addition to evaluating the parameters according to the appropriate guidelines, the relevant authorities should judge the relevance of the application of countercyclical capital requirements.

CBK, in Macroprudence Policy , lists the instrument of countercyclical capital requirements as a potential instrument of the intermediate objective of macroprudential policy to reduce and prevent excessive credit growth and leverage. According to the Basel Guidelines, the main parameter for determining the rate of countercyclical capital buffer is the credit gap to gross domestic product (GDP) in Kosovo, along with other relevant indicators that will inform the final decision on the possible activation of the instrument.

The deviation of the credit to GDP ratio from its long-term trend is the main parameter of the model. The calculation of the credit gap to GDP is performed based on the Basel Guidelines and the unified calculation practices from most countries in the world based on the recommendations from the empirical research, through one-sided Hodrik-Prescott filter (lambda 400,000).

In lending were included loans to the private sector by banks as well as non-bank financial institutions. The inclusion of non-banking sector loans, despite having a low share and currently without any significant effect on the credit gap result, ensures consistency in the calculation method with other countries, as well as ensures the inclusion of effects of the possible increase of the weight of lending to private sector by non-banking financial institutions.

Credit to GDP ratio of the private in Kosovo in 2021 stood at 52.9%. The results of the credit gap, at the end of June 2021, suggest that the private sector in Kosovo has shifted into the so-called “over lending” period. The “over lending” period has started since the first quarter of 2021, which is mainly due to the unprecedented economic contraction in 2020 and the

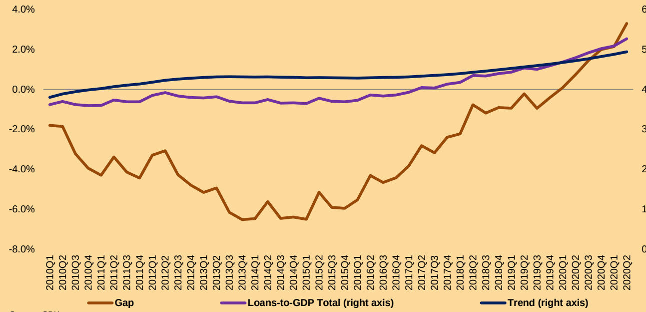
[5] For further details on the methodology of construction of the stability index of the banking sector, please refer to the Financial Stability Report no. 13.

effects transmitted in 2021, while lending has maintained a positive growth rate (an accelerated increase marked in June 2021 compared to the statement of the previous year).

As a result, in June 2021, the credit gap to GDP results in 3.302%, more widened in the positive plane compared to the same period of the previous year (+0.736%) (chart 1).

The positive widening of the credit gap to GDP in two recent periods means that lending is growing at a faster pace than the gross domestic product. While under normal conditions, this dynamic suggests over-lending and signaling the accumulation of systemic risk, and in this case it is more of a temporary effect caused by the pandemic crisis (unprecedented economic decline marked in 2020).

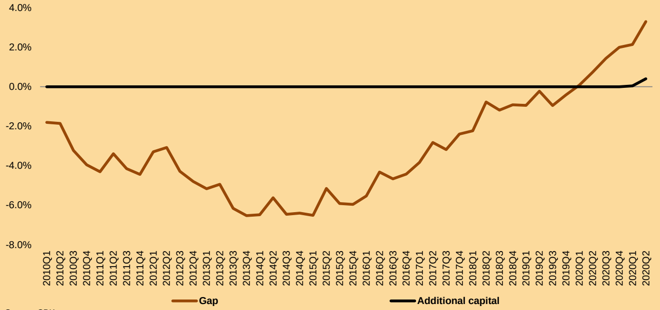
Chart 1. Lending gap



Source: CBK.

Consequently, in giving a judgmental assessment of the credit cycle, other financial and economic indicators, and in particular the judgment of experts, must be considered.

Chart 2. Countercyclical capital buffer



Source: CBK.

Moreover, other relevant indicators are monitored on regular basis along with the credit gap, which together with qualitative information and judgment of relevant experts, are assigned special weight in forming the final judgment about developments in the field of systemic risk and credit to GDP ratio.

These indicators, among others, include the dynamics of general lending growth and the growth in specific sectors, credit exposures in specific sectors, loans to collateral ratio, debt to income ratio, etc.

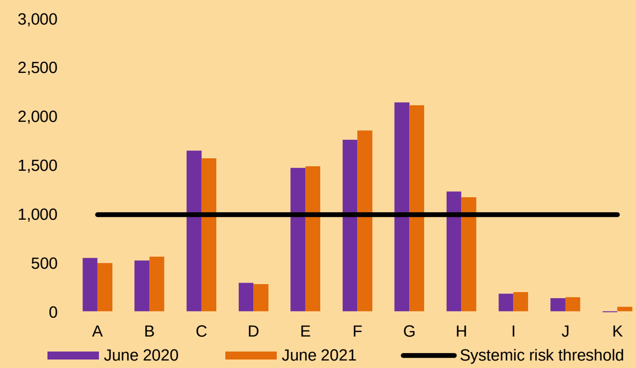
Box 3. Banks with systemic importance[6]

The model for identifying systemically important banks is an important tool for continuous assessment of the structural and cross-sectoral dimension of systemic risk associated with systemically important banks (table 1). General results of the model, based on the data of June 2021, suggest that five banks are with global systemic importance, similar to the same period of the previous year (chart 1).

Table 1. Indicators used o assess the systemic importance of banks in Kosovo

Criteria	Indicators
Size (weight 25%)	Assets (without provisions)
Substitutability (weight 25%)	Value of transactions to total transactions value ratio of the sector through payment system
	Share to total loans to households
	Share to total loans to nonfinancial corporations
	Share to total household deposits
Interconnectedness (weight 25%)	Share to total loans to other financial corporations and placements in other banks (excluding parent banks)
	Share to total financial corporation deposits and other borrowings (including also deposits of other banks)
	Share in securities
Cross-jurisdictional activity and complexity (weight 25%)	Claims to external sector
	Liabilities to external sector
	Share of off-balance items

Chart 1. General scale of systemic importance



Source: CBK.

All five banks with the global systemic importance result to have been with systemic importance in almost all constituent criteria of the model. Whereas, banks which did not result to be of global systemic importance, did not turn out to be such in any of the indicators. However, if we look at the sub-indicators, there are cases when 6 banks (maximum) and 2 banks (minimum) have resulted systematically important in that sub-indicator. The global scale of systemic importance ranges between 1,179 base points to 2,118 base points. This represents a slowdown decrease of the upper systemic degree (a decrease of 30 basis points), against the decline of the lowest degree of the systemic importance (a decline of 59 basis points).

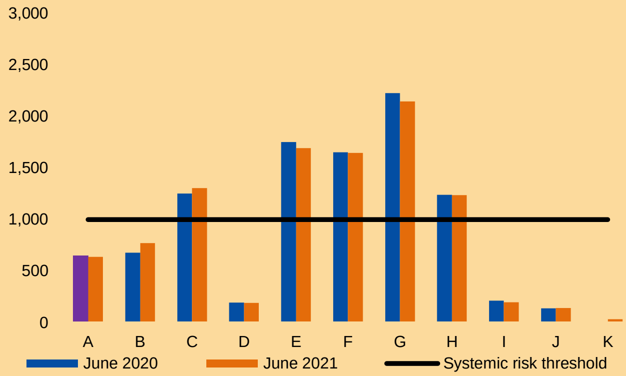
In general, banks with global systemic importance have declined the rate of systemic points, against the increase of the rate of points of banks that did not result to be of global systemic importance compared to the same period of the previous year. The beginning of the operation of a new bank with capital from Albania, which was licensed in the third quarter of the previous year, has also influenced the increase in the rate of points of the banks which have not resulted to be with systemic importance.

Criterion of Size: the scale of systemic importance in this criterion is ranged from 1,237 base points to 2,146 base points. Four of the five systemically important banks were

[6] For the theoretical basis and the complete methodology of evaluation of Banks with Systemic Importance, refer to the Working Paper no. 7 of the CBK with the title "Identification of Banks with Systemic Importance and Capital Buffer in Kosovo".

characterized by a decrease in systemic importance in this criterion compared to the previous period. This is an indication of a decrease in the degree of concentration of larger banks, which will increase competition and provide better and more favorable services to citizens and businesses.

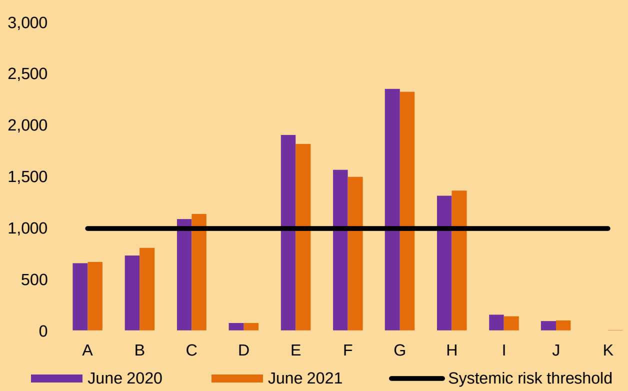
Chart 2. Criteria of size



Source: CBK.

Criterion of Substitutability: the scale of systemic importance in this criterion is ranged from 1,142 base points to 2,330 base points (chart 3). Three of the five banks with global systemic importance have marked a decrease in the systemic scale in this criterion compared to the previous period. While, with an increase were characterized most of the banks which had no global systemic importance. This was reflected in almost all respective subcategories.

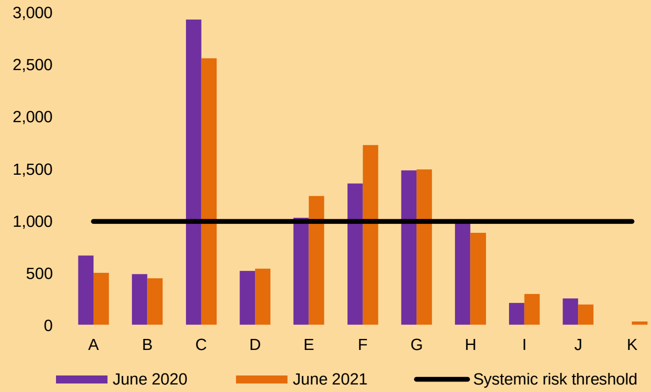
Chart 3. Criteria of substitutability



Source: CBK.

This dynamic was observed in the subcategories of lending to non-financial corporations, households, as well as deposits collected from households. Whereas, only in the interbank transactions indicator there is a non-significant increase in banks with global systemic importance against the decline in small banks.

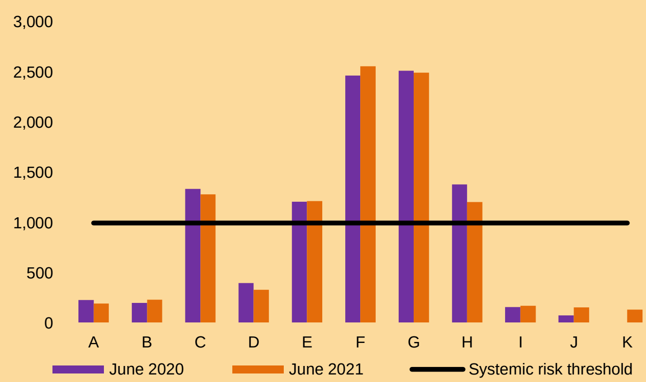
Chart 4. Criteria of interconnectedness



Source: CBK.

Criterion of Interconnectedness: this criterion is characterized by the largest fluctuations as banks can easily change their balance sheet with financial institutions, as well as investments in securities. The scale of systemic importance in this criterion ranges from 1,245 base points to 2,567 base points (chart 4).

Chart 5. Criteria of cross-jurisdictional activity and complexity



Source: CBK.

Banks of global systemic importance increased the points ratio significantly against the decrease of the points rating of banks which did not turn out to be of global systemic importance. This came as a result of more pronounced interaction with banks and financial institutions by large banks, compared to the lower level of interaction by small banks.

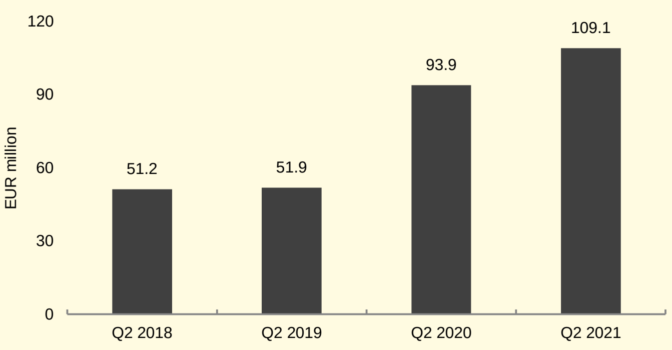
Criterion of cross-jurisdictional activity and complexity: the scale of systemic importance in this criterion ranges from 1,207 base points to 2,560 base points (chart 5). Compared to the previous period, the systemic importance scale marked a decline against the increase of the scale of banks which were with no systemic importance. This came as a result of the higher interaction with the external sector by non-systemic banks compared to the interaction by banks of global systemic importance.

In general, it should be noted that the sector has proven over the years that it is quite well capitalized and the application of capital buffer for systemically important banks, on Tier 1 capital as recommended by Basel and ABE, would not exceed the current level of regulatory capital of the banking sector in Kosovo.

Pension sector

As a result of the satisfactory performance of investments in financial markets, the activity of the pension sector expanded during Q2 2021. This expansion is mainly attributed to the positive return on investment and contributions received from contributors.

Chart 20. Assets of the pension sector, quarterly change



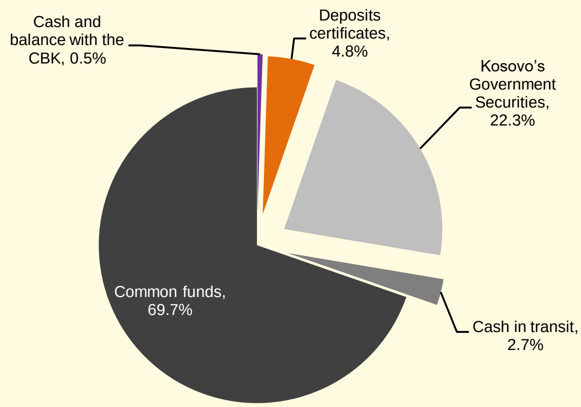
Source: CBK.

Pension sector, as the second sector by importance of weight in the financial sector, comprises 26.5% of total assets of the financial system. Despite of the 10% withdrawal of assets by the contributors, an opportunity which terminated in the beginning of the third quarter, total assets of the pension sector marked an annual increase of 7.5%, in June 2021, reaching the value of EUR 2.16 billion. Whereas, on quarterly basis, only in Q2 2021, assets of pension sector increased by EUR 109.1 million (a decline of EUR 93.9 million in Q2 2020) (chart 20).

Assets of the pension sector consist of 99.6% which belong to Kosovo Pension Saving Trust (KPST) and 0.4% of assets accounted for Slovenian-Kosovo Pension Fund (SKPF).

Assets structure of KPST is mainly comprised of assets invested abroad, albeit their weight gradually declined against the increase of the assets weight invested in the country. Around 72.3 per cent of KPST assets are held abroad. More specifically, in monetary terms, about EUR 1.50 billion are allocated to mutual funds and EUR 57.6 million are money in transit (chart 21).

Chart 21. Structure of KPST assets (Q2 2021)



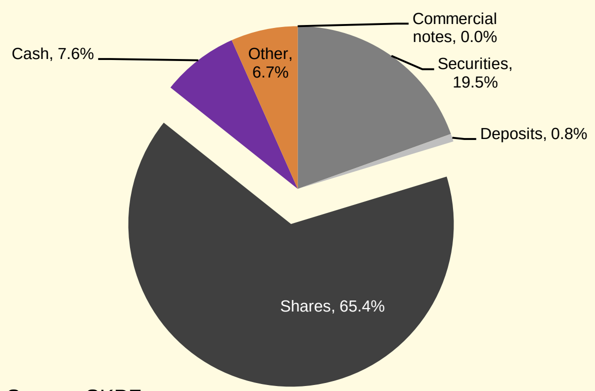
Source: KPST.

The remainder of assets were invested in the country, reaching the value of EUR 596.0 million at the end of June 2021. The largest portion of these assets are invested on treasury bonds and treasury bills of Kosovo's Government, which only in Q2 2021 marked an increase of EUR 19.9 million. Cash held at the Central Bank of Kosovo marked an increase of EUR 3.0 million. While, the category of assets invested in the banking sector shrank by EUR 17.1 million in this quarter.

The structure of SKPF assets is similar to that of KPST, where around 77.4% of them are invested abroad, and the remainder is invested in Kosovo. Portfolio of SKPF is mainly comprised of shares invested abroad (65.4%), treasury bonds of foreign governments and of Kosovo's Government (19.5%), cash (7.6%) and other instruments (7.4 %) (chart 22). Total assets of SKPF increased by EUR 246.3 thousands in Q2 2021, of which the majority were invested in the domestic sector.

During Q2 2021, the SKPF had negative return on investments with a value of EUR -132.6 thousands (EUR -1.6 thousands in Q2 2020). Whereas, the value of new collections of contributors amounted to EUR 123.5 thousands, in Q2 2021 (EUR 128.5 thousands in Q2 2020).

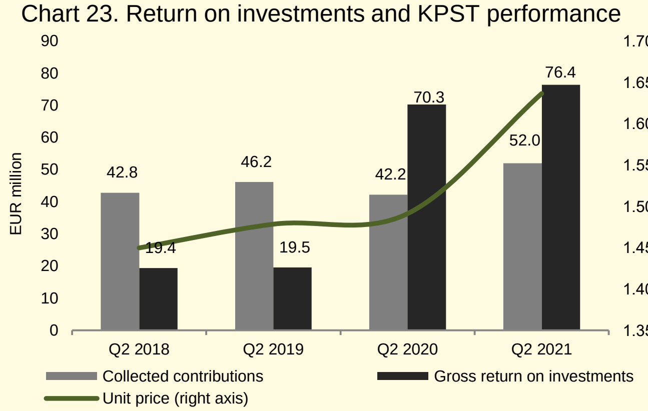
Chart 22. Structure of SKPF assets (Q2 2021)



Source: SKPF.

In this quarter, contributions collected by KPST increased by EUR 52.0 million, representing an increase of 23.1%, compared to the same period of the previous year.

Chart 23. Return on investments and KPST performance



Source: KPST.

KPST realized gross return on investments in the amount of EUR 76.4 million during Q2 2021, compared to the return of EUR 70.3 million marked in the same period of the previous year. In addition to the implementation of investment policies, the satisfactory performance of the KPST was also influenced by the diversification of the fund portfolio through new financial instruments, enabling a more favorable returns and risk allocation.

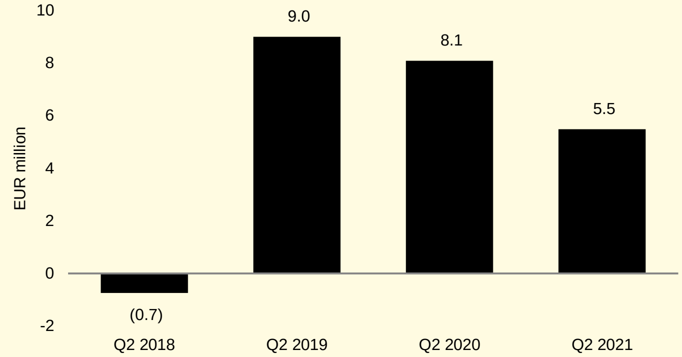
Insurance sector

Insurance sector during the second quarter of 2021 was characterized with an activity expansion. At the same time, the value of premiums collected exceeded the value of claims paid in particular and the expenses of the sector in general, which resulted in a positive performance of the sector in Q2 2021.

Assets of insurance sector by the end June 2021, reached the value of EUR 230.0 million, representing an annual growth of 10.3%. Deposits held at commercial banks and investments in Kosovo's Government securities were the items with the highest growth. Whereas, only during Q2 2021, assets of the insurance sector increased by EUR 5.5 million (chart 24), an increase supported mainly by receivables from the insurers, investments in securities, and deposits held at commercial banks.

Within capital and liabilities, in this quarter the highest increase was marked by technical reserves, primarily for premiums. While, reserves for claims increased at a lower level. The overall level of the capitalization of the sector was characterized by an increase. Only during this quarter, the total capital increased by EUR 1.1 million, whereas the value was EUR 60.0 million, at the end of June 2021. Total liabilities of the sector increased by EUR 4.4 million during this period, whose value reached EUR 170.1 million, at the end of June 2021.

Chart 24. Assets of the insurance sector, quarterly change



Source: CBK.

The value of gross written premiums of insurance companies, in Q2 2021, amounted to EUR 29.1 million, representing an annual growth of 26.2% (an annual growth of 9.4% in Q2 2020) (chart 25). "Non-life" premiums account for 96.0% of total written premium, whereas "life" premiums comprise 4.0%.

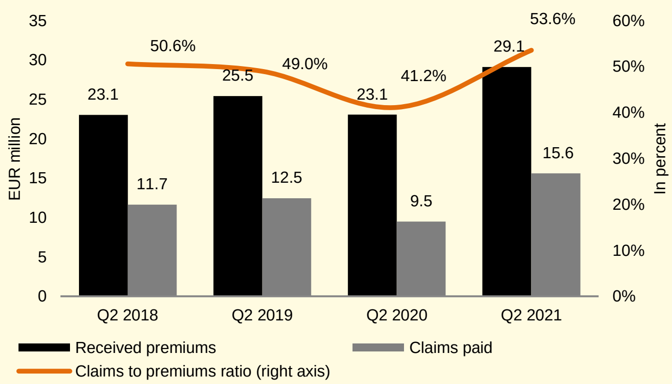
The value of claims paid by the insurance sector (including Kosovo Insurance Bureau) marked a growth in Q2 2021 against the same period of the previous year. In Q2 2021, claims paid reached a value of EUR 15.6 million (EUR 9.5 million in Q2 2020) (chart 25). As a percentage, claims during this period had a higher increase than written premiums, the claims to premiums ratio in Q2 2021 increased compared to the previous period, to 53.6% (chart 25).

Performance of the insurance sector

During Q2 2021, insurance sector performed with a net profit of EUR 2.1 million (a net profit of EUR 3.2 million in Q2 2020).[7]

The positive financial results during this quarter mainly reflect the higher level of receipts from written premiums compared to the level of claims incurred.

Chart 25. Written premiums and claims paid



Source: CBK.

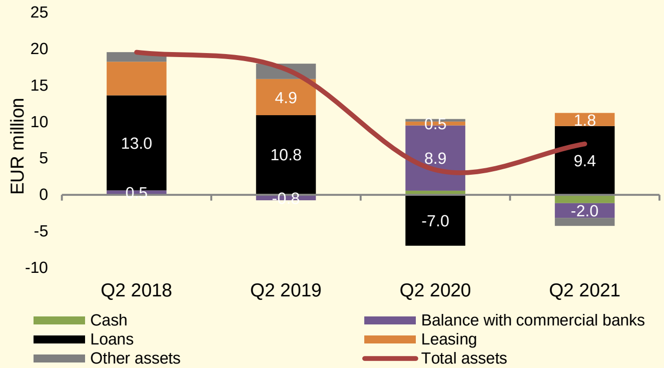
Microfinance sector

The growth of the sector's assets, mainly influenced by the growth of lending activity, as well as the increase of income against the decline in expenditures resulted in a positive performance of the sector during this quarter. Loans portfolio quality of the sector continued to be stable, based on the low rate of nonperforming loans.

Assets

The microfinance sector recorded a slower growth of assets of 3.0% (9.9% annual growth in June 2020), the value of which reached EUR 322.8 million at the end of June 2021.

Chart 26. Assets of the microfinance sector, quarterly change



Source: CBK.

However, on quarterly basis, assets contracted for EUR 7.0 million, during Q2 2021, compared to the increase of EUR 3.4 million marked in the same period of the previous year.

Expectations for the ease the restrictive measures during the second quarter and the increase in domestic inflows from the diaspora were translated into increasing sector confidence in the solvency of consumers, expectations that were translated into increasing demand but also credit supply and, consequently, increasing of microfinance sector assets.

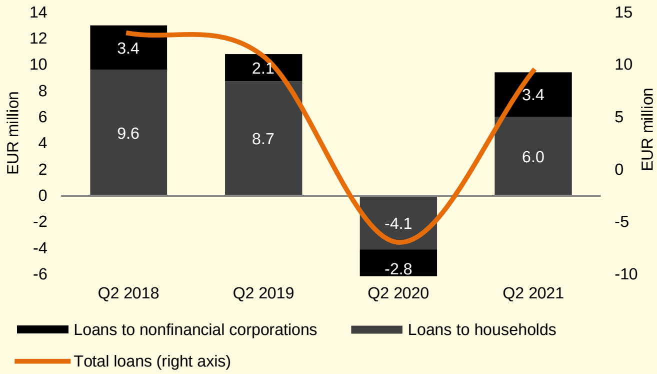
Loans

On annual basis, total loans issued by the microfinance sector marked a growth of 4.6% by the end of June 2021, while their stock reached the value of EUR 218.4

[7] From the net profit was deducted profit/loss of the insurance company which has been revoked the license in 2019.

million. Lending of the sector increased for both categories, nonfinancial corporations and households. Lending to households expanded at a rate of 3.9% (an annual decline of 0.3% marked in June 2020), reaching the value of EUR 143.7 million at the end of June 2021. Whereas, only in Q2 2021, loans to households increased by EUR 6.0 million (chart 27).

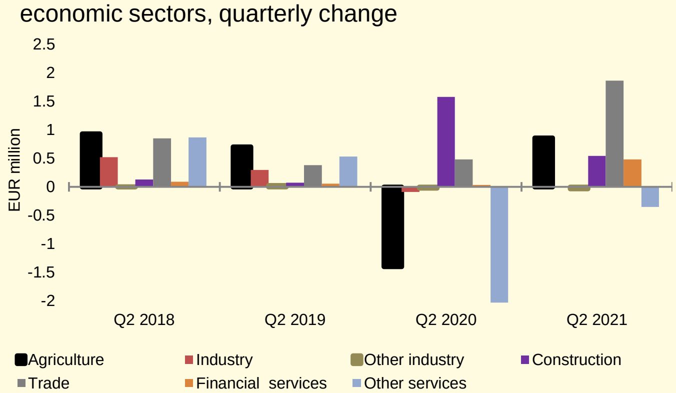
Chart 27. Value of loans to households and to nonfinancial corporations, quarterly change



Source: CBK.

Loans stock to nonfinancial corporations marked a value of EUR 74.8 million at the end of June 2021, representing an annual increase of 6.0% (an annual growth of 5.4% in June 2020).

Chart 28. Value of loans to nonfinancial corporations, by economic sectors, quarterly change



Source: CBK.

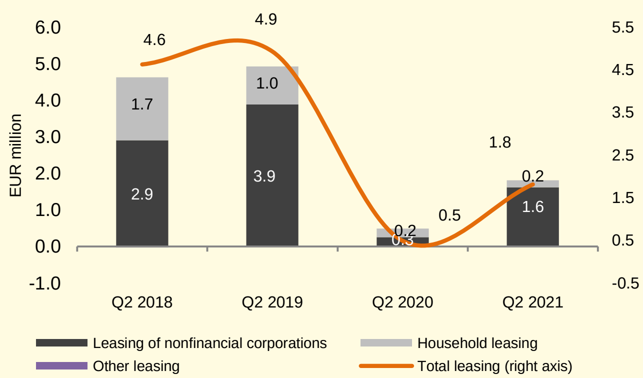
Whereas, on quarterly basis, during Q2 2021, loans to nonfinancial corporations increased by EUR 3.4 million.

On sectoral terms, on quarterly basis, lending to all the sectors was characterized with an increase, besides other services. However, the increase of lending was lower for the majority of the sectors. The highest increase was marked by trade sector, being followed by the sector of agriculture. Whereas, lending to industry sector and other industries stagnated in Q2 2021 (chart 28).

Leasing

On quarterly basis, also leasing were expanded during Q2 2021, albeit at lower level compared to the lending activity of the microfinance sector. The activity of leasing marked an increase with a value EUR 1.8 million during Q2 2021 (EUR 0.5 million in Q2 2020), reaching the value of EUR 59.4 million at the end of the period.

Chart 29. Value of microfinance sector leasing



Source: CBK.

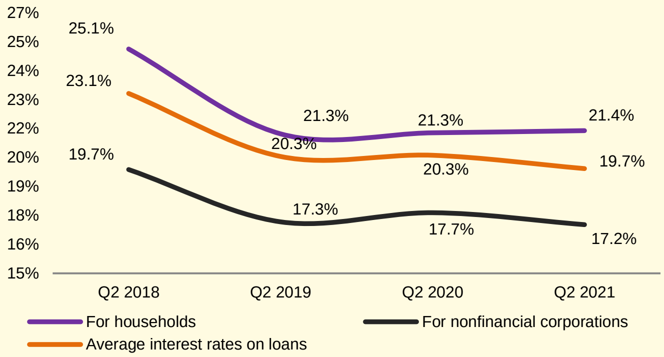
This increase mainly reflects leasing to nonfinancial corporations, the value of which increased by EUR 1.6 million during this quarter, reaching the value of EUR 33.4 million at the end of the period (chart 29).

Also, leasing to households increased by EUR 0.2 million during Q2 2021, and their total value reached EUR 26.0 million at the end of June 2021.

Interest rates

During the first quarter of 2021, the average interest rate on issued loans was 19.7%, or for 0.6 percentage points lower compared to the same period of the previous year (chart 30).

Chart 30. Average interest rate on microfinance sector loans

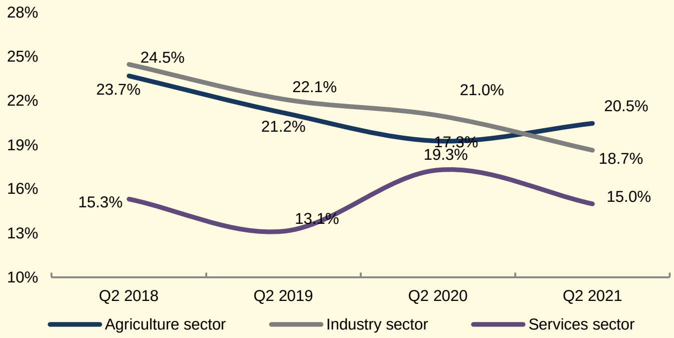


Source: CBK.

Interest rates on loans marked an annual increase of 0.1 percentage points reaching 21.4% during Q2 2021 (chart 30). By loan categories, the average interest rate on mortgage loans decreased by 2.7 percentage points falling at 19.9%, in Q2 2021. Whereas, consumer credit were characterized with an increase of 2.5 percentage points, reaching 23.2%.

Also, the average interest rate on loans to nonfinancial corporations decreased by 0.5 percentage points, dropping at 17.2%. On sectoral terms, a more favorable interest rate was marked by loans to services sector, followed by loans to industry sector.

Chart 31. Average interest rate on loans to enterprises, by economic sectors



Source: CBK.

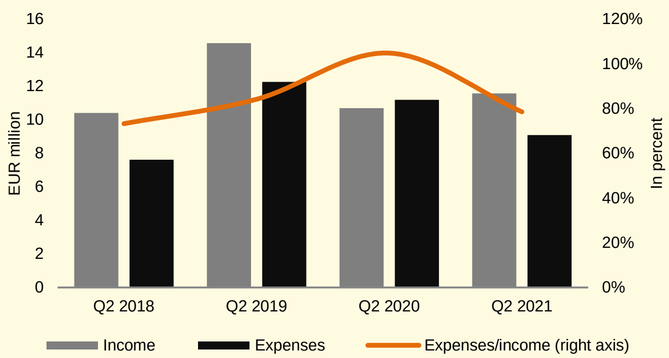
The quarterly average interest rate on loans to services and industry marked an annual decline of 2.3 and 2.4 percentage points, respectively. Whereas, an increase of 1.2 percentage points was marked by interest rates on loans to agriculture (chart 31).

Performance of the microfinance sector

The microfinance sector closed the second quarter of 2021 with a net profit of EUR 5.2 million, representing a growth of EUR 2.3 million, in Q2 2021. Whereas, during the same period of the previous year, this sector operated with a loss of EUR 3.1 million. The positive financial performance in this quarter was mainly a result of the decline of expenditures against the increase of income. During this quarter, the income of the sector amounted to EUR 11.6 million, representing a growth of EUR 0.9 million compared to the same quarter of the previous year. The increase was attributable to the increase of interest income for EUR 0.5 million, reaching EUR 10.5 million during Q2 2021 (chart 32). Also, non-interest income increased by EUR 0.4 million, reaching EUR 1.1 million, where the increase of other operating income has the largest growth weight.

Expenditures of the sector marked the value of EUR 9.1 million in Q2 2021, representing a value which is lower for EUR 2.1 million compared to the same quarter of the previous year. The decline of expenses mainly reflects the decrease of non-interest expenses, namely loan loss provisions. At the same time, interest expenses marked a slight decline, while operating expenses marked an increase.

Chart 32. Microfinance sector income and expenses

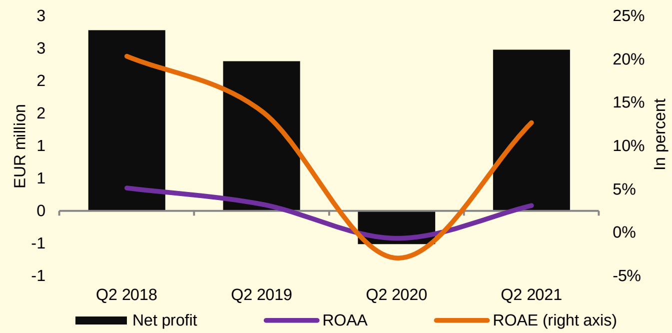


Source: CBK.

As a consequence of the recovery of sector's performance, expenses to income ratio marked a significant recovery, declining for 26.2 percentage points compared to the same period of the previous year, standing at the level of 78.6%, in Q2 2021. This implies that for every EUR 1 invested, the microfinance sector spends around EUR 0.786.

The financial performance of the sector was reflected also on two other profitability indicators, return on average assets (ROAA) and return on average equity (ROAE), which considerably increased in Q2 2021 at 3.1% and 12.7%, respectively, compared to the negative values marked in Q2 2020 (chart 33).

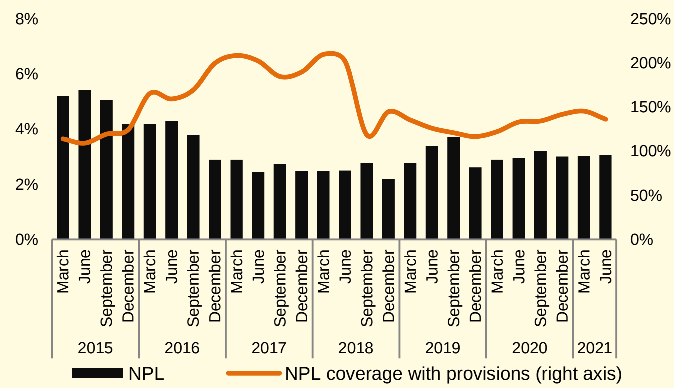
Chart 33. Profitability indicators of microfinance sector



*Profit was annualized for the respective quarter
Source: CBK.

Regarding the indicators of loans portfolio quality in microfinance institutions, nonperforming loans continued to stand at low levels and were characterized with good coverage with provisions. Until the end of the period, nonperforming loans stood at 3.1%, while the NPL coverage with provisions reached 136.6%, at the end of Q2 2021 (chart 34).

Chart 34. Indicators of loans portfolio quality

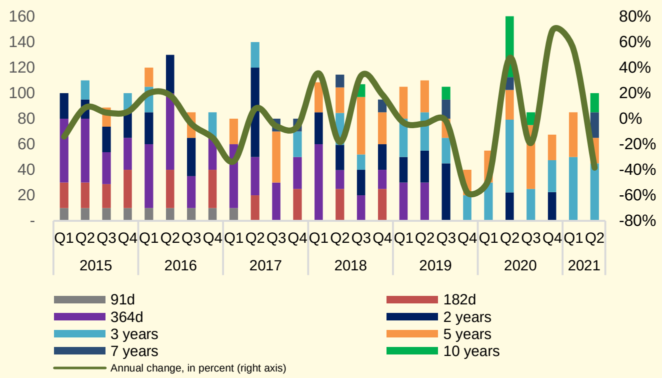


Source: CBK.

Securities market

During the second quarter of 2021, Kosovo's Government issued debt with a lower value compared to the same quarter of 2020, albeit with higher value compared to the previous quarter. Also, the demand to invest in Kosovo's Government securities exceeded the offer.

Chart 35. Amount of issued debt, annual change

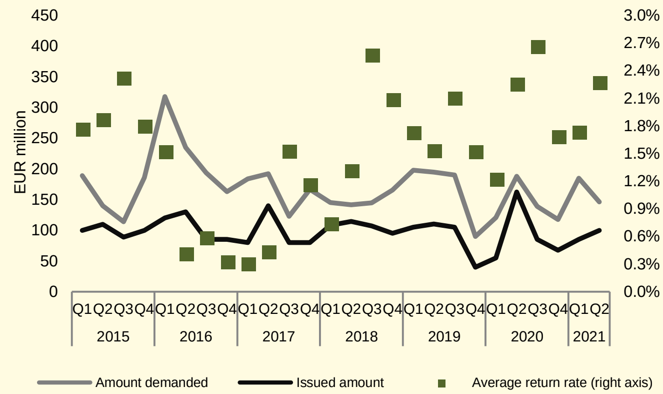


Source: Ministry of Finance.

The debt issued by Kosovo's Government marked an annual decline of 38.4% in Q2 2021, compared to Q2 2020, resulting at the value of EUR 100.0 million (chart 35).

The demand to invest in Kosovo's Government securities continued to exceed the offer, where the bidding amount, in Q2 2021, was for 1.46 times higher than the amount offered by the Kosovo's Government. The average interest rate on securities was 2.3% in Q2 2021, representing the same rate marked in Q2 2020 (chart 36). The increase of interest rate compared to the previous period reflects the trend of securities issuance towards long-term maturities.

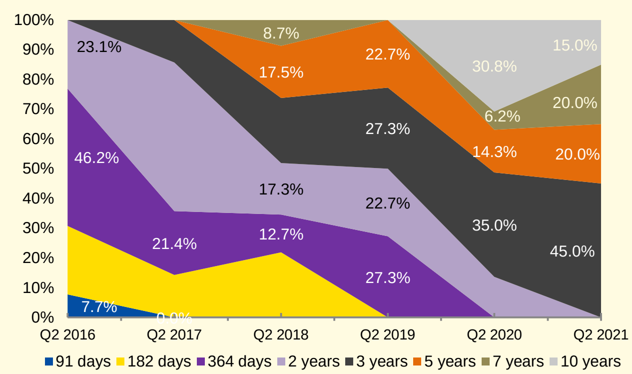
Chart 36. Bid to cover ratio



Source: Ministry of Finance.

The securities structure is dominated by government bonds, with a maturity of 3 years, followed by securities with a 5 and 7 year maturity (chart 37).

Chart 37. Government securities structure, in percent



Source: Ministry of Finance.

It is worth noting that for the second consecutive year, there is no issuance of treasury bills, whose longest maturity does not exceed 364 days.

The banking sector, pension funds and insurance companies continued to represent the investment institutions in the primary market of Kosovo's Government securities, where the pension sector continues to be the most exposed sector.

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CBK (2021): Quarterly Assessment of Financial System No. 35 Q2 2021, Central Bank of the Republic of Kosovo, Prishtina

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Macroeconomic selected indicators

Description	June 2020	June 2021
Real sector 1/		
Gross Domestic Product (GDP) (in millions of EUR)*	1,409.9	1,492.6
Consumer prices (annual average)	0.6%	1.3%
Consumer prices (end of period)	0.1%	2.4%
Fiscal Sector 2/		
Budget Revenues (in millions of EUR)	760.3	982.5
Budget Expenditures (in millions of EUR)	877.5	968.3
Primary balance (in millions of EUR)	-117.2	14.2
Financial sector (in millions of EUR) 3/		
Assets of financial corporations	7,406.9	8,309.2
of which : Banks	4,849.0	5,568.9
Loans	3,127.4	3,510.1
Deposits	3,903.2	4,477.8
Interest Rates on Loans, end of period	6.3%	6.0%
Interest Rates on Loans, end of period	1.5%	1.3%
Interest rate gap	4.7%	4.7%
External sector,(in millions of EUR) 3/		
Balance of payments		
Current accounts	-217.3	-449.6
of which: remittances	434.9	552.0
Financial account	-311.8	-256.9
Foreign Direct Investments in Kosovo	173.5	230.1
Portfolio investments, net	-389.1	42.1
Other investments, net	195.5	-132.2
International Investment Position (PNI), net*	-592.2	-887.4
Assets	5,054.3	5,348.4
Liabilities	5,646.6	6,235.8
External debt, total*	2,206.9	2,513.8
Private external debt	1,717.5	1,907.3
Public external debt	489.4	606.5

Source:
1/ KAS (2021);
2/ MF (2021);
3/ CBK (2021).
*Data on GDP, IIP and external debt are as of March 2021.